Project On Government Oversight
Watchdog since 1981

January 31, 2000

David S. Guzy, Chief
Rules & Publications Staff
Royalty Management Program
Minerals Management Services
P.O. Box 25165, MS 3021
Denver, CO 80225

Attn: Further Supplementary Proposed Rulemaking Establishing Oil Value for Royalty Due on Federal Leases

Dear Mr. Guzy:

We support finalizing Minerals Management Service's (MMS) proposed Oil Valuation Rule, and urge the Department of Interior to implement the Rule as soon as the Congressional moratorium is lifted on March 15, 2000. Every year that implementation of the Rule is delayed costs American taxpayers and Native Americans $72 million. However, because MMS has decided to re-open the Rule for public comment, we would like to make the following comments.

Whistleblowers joined by the Justice Department in "qui tam" litigation over these issues argue in their complaint that companies have systematically sold oil to each other at below-market value with the intent of shortchanging the federal government of royalties. Their litigation alleges that since 1988, oil companies have submitted more than 500,000 false or fraudulent oil royalty payment claims to the federal government. Since the last public comment period, oil companies have announced nearly $300 million in settlements or near settlements with the Justice Department over these allegations. Policy reforms are sorely needed to prevent future litigation of this kind.

While the general direction of the Rule will clearly make it easier for MMS to collect royalties owed by major oil companies, the proposed Rule as it currently stands provides an overly reduced reporting burden on industry. In other words, MMS is placing the burden on itself to detect underpayments through audits, rather placing the burden on industry to disclose the relevant information.

This strategy is particularly flawed because, despite their best efforts, MMS auditors have not been able to acquire documents that have been essential to revealing how oil companies value oil in their sales transactions -- what many policymakers have called the "second set of books."

1900 L Street, NW, Suite 314 • Washington, DC 20036-5027 • (202) 466-5539
Fax: (202) 466-5596 • E-mail: pogo@pogo.org • http://www.pogo.org

A) Overall Balancing Provision. In 1998, John Price, Chief of the Oil and Gas Valuation Branch with the Royalty Valuation and Standards Division of MMS testified in the Justice Department litigation that MMS auditors had no knowledge of the major oil companies' use of overall balancing arrangements:

> *"Q. So in terms of overall balancing agreement that I have described, which is this global agreement between two companies to balance purchases and sales over some time period at posting price - at posted price, the existence of those agreements have never been disclosed to you by any defendant in this case? Talking about this case.*
>
> *Answer: No.*
>
> *Q. Are you aware of them being disclosed to anybody at MMS other than as part of this case?*
>
> *Answer: No"*

According to Mr. Price's testimony, MMS has never been able to verify the existence of overall balancing agreements through auditing or other venues. Yet, documents acquired during litigation discovery from both Conoco and Amoco confirm the industry-wide use of overall balancing arrangements.

Because of this, it is imperative that MMS require companies to disclose overall balancing arrangements and provide stiff penalties if they fail to do so. In the litigation, whistleblowers have alleged an "active concealment of the conspiratorial and confederated manner in which they [major oil companies] used buy/sells and overall balancing to underpay royalty obligations [including those owed to the United States]." To support their claim, they cite Conoco executive James Svenvold who in testimony on January 16, 1997 denied the existence of the arrangements, when in fact they had been in effect for more than a decade:

> *"Q. There has been testimony in this case, Mr. Svenvold that - by Mr. Johnson [one of the Relators in this qui tam litigation], again that all of the defendants in this case have overall - what he called overall balancing arrangements with each other during the entire applicable time period we're talking about. Is that a correct statement?*
>
> *A. That's an absolute fabrication and false.*
>
> *Q. Let me just ask you, you're one of the top management of Conoco, does Conoco have an overall balancing arrangement with any of the other named defendants in this case?*
>
> *A. No."*

Citing a hearing transcript, the complaint continues:

"Despite Mr. Svenvold's testimony [which he offered as the designee of the defendants in the New Mexico litigation (all of whom are defendants in this action)], a Conoco document produced in the MDL 1206 litigation squarely contradicts each aspect of Mr. Svenvold's cited sworn testimony. The document is entitled "Overall Exchange Balances" and it unequivocally establishes that overall balancing has been a significant part of Conoco's crude oil marketing since the early 1980's and continuing through at least 1994. In fact, Conoco developed a new computerized system in 1994 to better facilitate their monitoring of their own balances. Conoco regularly initiated the calls to other oil companies to balance (including all of the Defendants in this action who had significant dealings with Conoco)...."

B) Tracing. Second, we are concerned that MMS has not limited the number of non-arm's-length transactions that must be traced by MMS auditors in order to determine the final gross proceeds of an arm's-length sale. We believe it is unrealistic to expect auditors to bear this burden, as history has shown us how difficult it has been for MMS auditors to capture true gross proceeds through the complicated chains of exchanges and sales between and within companies. We believe that it is reasonable to limit to two the number of transactions government auditors are expected to trace for gross proceeds. Otherwise we believe the current proposal will result in likely lost royalty revenues to the government.

We therefore recommend that in cases where more than two non-arm's-length transactions take place prior to the arm's-length sale that the company be required to pay royalty based on index prices.

C) Location and Quality Differentials. We believe the proposal to eliminate MMS-published location and quality differentials will again put MMS auditors at a disadvantage when trying to determine underpayment of royalties. These differentials are the deductions companies are allowed under the rule to reduce their royalty payments to the government. Therefore, it is important that MMS have a firm grasp on the reasoning behind the amounts of these deductions and the information needed to confirm that industry standards are used with the federal government. As the proposed language now stands, MMS may be giving companies the ability to deduct the entire cost of transporting from the lease to the refinery, rather than having that deduction limited to the cost of transporting from the lease to the index pricing point. We are opposed to this and ask that MMS require the use of standardized location differentials. It would put the government on a more even playing field if these differentials were standardized and made publicly available.

D) Secretarial Re-determinations. Finally, we believe that if MMS provides for Secretarial re-determinations of value indicators, that such new indicators be required to provide the same safeguards as those in the proposed rule -- transparency based on a competitive open market.

We hope this is the last time this rule is re-opened for comment. As Susan Kladiva of the GAO testified in Congress in May, 1999 regarding their review of MMS' rule making process: "...the General Accounting Office is not too prone to be complimentary of agencies when we do work...we [GAO] believe that they've [MMS] been deliberate and that they have taken all due care to include the positions and to respond to the positions that have been put forth by the states, as well as the industry...So it appears to be a long time. But we believe that it has been thoughtfully approached."

We do too. Please move forward and implement the rule.

Sincerely,

Danielle Brian
Executive Director